

International Financial Reporting Standards and Aggressive Reporting: An Investigation of Proposed Auditor Judgment Guidance

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ABSTRACT: We experimentally investigate auditors' judgments under accounting standards that differ in their precision. After establishing conditions under which auditors accept managements' aggressive financial reporting, we examine the effectiveness of alternative judgment frameworks in helping auditors curb this aggressive reporting under less precise International Financial Reporting Standards (IFRS) and more precise U.S. GAAP. One of our frameworks is based on the Securities and Exchange Commission's (SEC) Advisory Committee on Improvements to Financial Reporting's (CIFI_R) recommendation to use counterfactual reasoning. Another framework based on Construal Level Theory requires auditors to think broadly about a transaction, while our last framework is based on both counterfactual reasoning and Construal Level Theory.

We find that auditors' ability to restrain managers' opportunistic judgments under less precise IFRS depends on the economic substance of the transaction. We also find that a judgment framework helps auditors curb managements' aggressive accounting under IFRS. Additionally, the judgment frameworks based on Construal Level Theory are more effective than the framework based on CIFI_R's proposed judgment guidance when the transaction's economic substance is clear, while the framework based on CIFI_R's proposed guidance is just as effective when the economic substance is unclear. These results inform regulators, standard-setters, and auditors on the effectiveness of different judgment guidance in improving auditors' judgments under less precise IFRS.

INTRODUCTION

The Securities and Exchange Commission (SEC) recently reconfirmed its support of the adoption of a global set of accounting standards such as the International Financial Reporting Standards (IFRS) as early as 2015 (SEC 2010). Proponents of IFRS argue that the adoption of one set of principles-based accounting standards will result in increased comparability and simplicity in financial reporting that will ultimately benefit the investor. However, there are concerns about the move to IFRS because IFRS is a more general, less precise set of standards than U.S. Generally Accepted Accounting Principles (GAAP). One concern is whether auditors can restrain managers' aggressive financial reporting under IFRS without the bright lines present in U.S. GAAP (SEC 2008). Another concern is whether investors and the courts will respect auditors' judgments when they are not supported by precise guidance (PCAOB 2008). In response to these concerns, the Advisory Committee on Improvements to Financial Reporting (CIFIr) proposed guidance on the components of a well-reasoned professional judgment to be used to support and evaluate auditors' judgments (FEI 2008, CIFIr 2008).¹ In this study, we examine the joint effects of IFRS and the proposed judgment guidance on auditors' decisions. We first establish conditions under which auditors are more likely to accept managements' aggressive financial reporting under accounting standards that differ in their level of precision, and then we examine the effectiveness of judgment guidance in helping auditors curb managers' aggressive financial reporting under less precise IFRS.

Standard setters and regulators are concerned about the quality of auditors' judgments. Specifically, the FASB worries that auditors rely too heavily on rules, and are reluctant to use

¹ In recommendation 3.5 of CIFIr's final report, CIFIr recommends that the PCAOB develop guidance as to how it evaluates the reasonableness of auditors' judgments (CIFIr 2008). However, CIFIr notes that the PCAOB should rely on the SEC's judgment guidance when evaluating accounting judgments. As yet, the SEC has not issued such guidance.

their professional judgment in subjective areas (FASB 2004; Essaiades 2006). Further, the PCAOB is concerned that auditors are too compliance-oriented and not sufficiently fraud-oriented to effectively deter managements' aggressive reporting (Carmichael 2003; PCAOB 2004, 2007; Hammersley et al. 2010).² Accounting literature supports these concerns. For example, Hackenbrack and Nelson (1996) and Kadous et al. (2003) find that auditors exploit the ambiguity in certain U.S. GAAP standards to justify the client-preferred aggressive accounting method. More recently, Jamal and Tan (2010) examine managers' proclivity to engage in aggressive reporting under principles-based versus rules-based financial reporting standards.³ They find that the type of auditor mindset (i.e., principles-oriented, rules-oriented) does not affect managers' reporting when financial reporting is rules-based. However, under principles-based financial reporting, managers are less likely to aggressively report when the auditor is also principles-oriented as opposed to rules-oriented. Given that IFRS are typically less precise standards than U.S. GAAP (SEC 2003; Hail et al. 2010) and prior accounting research suggests that auditors may be increasingly vulnerable to managers' aggressive reporting under less precise standards, it is important to investigate approaches to help auditors curb aggressive reporting under IFRS.

In anticipation of the adoption of less precise IFRS, CIFIr proposed judgment guidance aimed at improving the quality of auditors' judgments and encouraging consistent auditor evaluation practices (CIFIr 2008). The goal of the proposed guidance is to encourage auditors to follow a disciplined process in making judgments. This process would entail a "critical and

² Consistent with Hammersley et al. (2010), auditors that are compliance-oriented are relatively more focused on completing the audit program steps whereas auditors that are fraud-oriented are relatively more focused on detecting fraud.

³ Jamal and Tan (2010) follow prior research and adopt the definitions of principles-based standards and rules-based standards provided in the SEC 2003 report. This report suggests that standards are principles-based if they are based on a consistently applied conceptual framework with a clearly stated accounting principle, provide less implementation guidance, and have fewer bright line tests than rules-based standards.

reasoned evaluation made in good faith,” including the consideration of the underlying economics of the transaction and the evaluation of pros and cons of all reasonable alternative accounting methods (CIFI_R 2008, p. 94-95).⁴ In other words, CIFI_R suggests that auditors’ consideration of the pros and cons of the accounting method alternatives will increase auditors’ propensity to accept the most appropriate (rather than the client-preferred) accounting method, even when faced with less precise accounting standards. However, there is no evidence on how this proposed guidance would affect the quality of auditors’ judgments.

Recent theory in psychology (Construal Level Theory: Liberman and Trope 1998; Trope and Liberman 2003; Trope et al. 2007) suggests a modification to this guidance that may help auditors to think critically about the client’s preference to engage in aggressive reporting. Construal Level Theory proposes that individuals who psychologically distance themselves from an outcome represent the event at a high-level which fosters a deliberative mindset and the impartial processing of all available alternatives (Frietas et al. 2004). Applying this theory in an auditing context suggests that psychological distance from the client’s aggressive reporting preference will allow auditors to focus on the economic substance (rather than the structured form) of the transaction.

We conducted an experiment to investigate these issues. Auditors from a Big 4 accounting firm participated in an experiment that employed a 2 X 2 X 4 mixed design. We manipulated three independent variables: transaction, accounting standard precision, and judgment framework. The first independent variable, *transaction*, was manipulated within

⁴ CIFI_R identifies 11 key components to a reasonable accounting judgment. We study the use of counterfactual reasoning based on CIFI_R’s suggestion that one of the key factors that the SEC should consider when evaluating the reasonableness of an accounting judgment is the analysis of alternative views or estimates, including pros and cons for reasonable alternatives (CIFI_R 2008). Several of the Big 4 accounting firms have already developed judgment frameworks based on CIFI_R’s proposed guidance. For example, Deloitte (2009) describes issue analysis as including the analysis of the pros and cons of the reasonable alternatives.

participants. All participants analyzed (1) the classification of a lease transaction, and (2) the revenue recognition for a bundled (good and service) transaction.⁵ The second independent variable, *accounting standard precision* was manipulated between participants. The relatively precise standards refer to the transaction-specific standards under U.S. GAAP that are currently in practice, while the imprecise standards are transaction-specific IFRS standards that are implemented internationally and are slated to be adopted in the U.S.⁶ We manipulated *accounting standard precision* by varying the accounting standard applicable to the client.

The third independent variable, *judgment framework* (no framework, counterfactual framework, why framework, hybrid framework), was also varied between participants. Participants in the *no framework* condition consider the applicable authoritative guidance under either U.S. GAAP or IFRS. This condition mirrors the current auditing environment where auditors do not use a formal judgment framework. The second condition, the *counterfactual framework*, requires auditors to consider the pros and cons of the different accounting method alternatives. CIFIIR highlights this type of counterfactual reasoning as a key component to reasonable auditing judgments (CIFIIR 2008). Our third condition (the *why framework*) relies on Construal Level Theory to psychologically distance auditors from the client's preference, while our fourth condition (the *hybrid framework*) asks auditors to use both counterfactual reasoning and psychological distancing.

⁵ As explained shortly, the clarity of the economic substance of the lease transaction differed from that of the revenue transaction. We chose the lease classification scenario because it is a good example of a bright-line standard that allows managers to opportunistically structure a transaction to ensure a preferred way of accounting (Maines et al. 2003; Jamal and Tan 2010). Investigating revenue recognition is also important as it has received significant attention among regulators and standard setters as an area where IFRS and U.S. GAAP are likely to have significant differences allowing room for management's aggressive reporting (Leone 2007; Scannel and Slate 2008; Byrnes and Epstein 2008). Interestingly, the FASB and IASB under their standards convergence project have issued exposure drafts for both leases and revenue recognition.

⁶ We used the lease classification criteria found in FASB Accounting Standards Codification 840-10-25-1 and International Accounting Standard 17 for our manipulation of U.S. GAAP and IFRS applicable to the lease task, respectively. We used the guidance found in FASB Accounting Standards Codification 605-25 related to the revenue recognition for multiple element sales arrangements and International Accounting Standard 18 for our manipulation of U.S. GAAP and IFRS applicable to the revenue task, respectively.

The case materials for all conditions presented the client as preferring aggressive accounting methods. Specifically, the client preferred (1) to classify the lease as operating in order to aggressively move debt off of the balance sheet, and (2) to recognize revenue associated with the bundled arrangement in the current period. The structuring of the lease meets all of the bright-line tests that allow for this aggressive classification under U.S. GAAP, but the transaction's economic substance argues against such aggressive classification under IFRS. The economic substance of the (bundled) revenue transaction is less clear so the client's preference to aggressively recognize revenue is arguably allowed under IFRS, but recognition is questionable under U.S. GAAP due to failure to satisfy the bright-line tests. This contrast between the standards and the transactions provides a balanced-design to examine auditors' responses to the client's aggressive reporting under both U.S. GAAP and IFRS. Given the characteristics of our two transactions, U.S. GAAP's bright line standards for lease (revenue) accounting hinder (help) auditors' ability to curb the client's aggressive reporting; under IFRS, the less precise standards for lease (revenue) accounting help (hinder) auditors' ability to curb the client's aggressive reporting.

Consistent with our expectations, we find that both U.S. GAAP and IFRS can help or hinder auditors' ability to curb the client's aggressive reporting. Auditors were less likely to accept the client-preferred accounting method for the lease transaction under IFRS than U.S. GAAP, but they were more likely to accept the client-preferred revenue recognition method under IFRS than U.S. GAAP. This suggests that IFRS alone are not the solution to restraining aggressive reporting. As predicted, we find that employing a judgment framework curbs auditors' acceptance of the client-preferred aggressive reporting under less precise IFRS, but not under more precise U.S. GAAP. Further, the judgment frameworks we developed based on

Construal Level Theory are most effective in helping auditors curb aggressive reporting when the transaction's economic substance is clear, but the counterfactual framework based on CIFIr's recommendations is just as effective when the underlying economic substance is unclear.

Our study is important for several reasons. First, we contribute to the auditor judgment literature by being the first to experimentally examine auditors' determination of the correct accounting treatment under less precise IFRS standards as compared to U.S. GAAP. Our findings provide insight into concerns expressed by regulators and others regarding whether auditors can restrain managers' opportunistic judgments under IFRS without the bright lines present in U.S. GAAP. We show that IFRS alone will not mitigate opportunistic financial reporting. Just as bright line U.S. GAAP standards have the potential to either constrain or facilitate management's aggressive reporting, less precise IFRS standards have the same potential. Specifically, the less precise standards can constrain aggressive reporting when analysis of the economic substance of the transaction results in an unambiguously appropriate accounting method, but not when the analysis involves ambiguity and the appropriate accounting is uncertain. We believe that such ambiguity will be common in today's complex financial reporting environment.

Second, our findings provide evidence on the potential of CIFIr's recommendations to improve audit quality and, in particular, to bolster auditors' ability to restrain managers' aggressive reporting. At the center of the proposed professional judgment guidance is auditors' use and documentation of counterfactual reasoning. Our reliance on Construal Level Theory suggests a modification that may improve the effectiveness of CIFIr's recommendations – using a judgment framework that requires the auditor to think broadly and in so doing psychologically

distances the auditor from the client's aggressive reporting preference. Our study is therefore helpful to standard-setters as they consider the costs and benefits of the proposed auditor judgment guidance.

Third, Construal Level Theory has implications for the concern that auditors exhibit insufficient professional skepticism. While there is widespread concern about this issue, research provides little in the way of concrete steps to enhance professional skepticism (Nelson 2009). Construal Level Theory provides insights into why auditors may not always exhibit the appropriate professional skepticism and, by highlighting specific steps to foster a deliberative mindset, how to enhance professional skepticism.

The remainder of the paper is organized as follows. Section II provides background information, summarizes the theory underlying our analysis, and develops our hypotheses. Section III describes the sample and experimental design, Section IV presents the results of our study, and Section V concludes.

I. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Auditors' Judgments and Accounting Standard Precision

The possible switch from more precise U.S. GAAP to less precise IFRS has spurred a great debate. The SEC's (2003) study of a principles-based accounting system for the U.S. summarizes the issue as follows:

Principles-only standards may present enforcement difficulties because they provide little guidance or structure for exercising professional judgment by preparers and auditors. Rules-based standards often provide a vehicle for circumventing the intention of the standard (SEC 2003).

The study concludes by supporting less precise, principles-based standards that allow the accounting to best capture the underlying economic reality. That is, by providing less specific guidance that can distract from the underlying accounting principle, more general standards can

reinforce the role of accounting principle.⁷ Nevertheless, opponents of the switch to IFRS warn that the latitude inherent in these less precise standards is a double-edged sword. Such latitude allows managers to choose accounting methods that reflect their informed understanding of the underlying economics of the transactions, but it also permits managers to opportunistically advocate reporting methods that do not necessarily capture the economics of the transactions (Maines et al. 2003; Hail et al. 2010). Based on their analysis and review of the archival literature, Hail et al. (2010) conclude that IFRS adoption is unlikely to improve reporting quality in the U.S. However, they do recognize that increased management discretion under IFRS is likely to make SEC enforcement, firms' internal controls and, we would add, the external audit more important for reporting quality.

Extant research provides little insight on the audit implications of the switch to an accounting system less dependent on specific guidance. Instead, the implications of this move for managers' (as opposed to auditors') judgments and decisions are the focus of two recent studies (e.g., Jamal and Tan 2010; Agoglia et al. 2011). Agoglia et al. (2011) examine the influence of accounting standard precision on financial managers' reporting decisions. They find that preparers' concerns about second-guessing and the costs associated with regulation and litigation increases managers' focus on the underlying economics of the transaction resulting in less aggressive reporting. Jamal and Tan (2010) find that less precise, principles-based accounting standards will be associated with preparers' less aggressive reporting only when the auditor also has a principles-oriented mindset. However, it is not clear how to ensure that auditors have the necessary principles-oriented mindset to curb aggressive reporting under IFRS.

⁷ The SEC has described U.S. GAAP as rules-based when drawing comparisons to IFRS, a principles-based set of standards (SEC 2008, 2010). Others (e.g., Schipper 2003; Hail et al. 2010) argue that U.S. GAAP is principle-based but over time has accumulated more guidance. However, Hail et al. (2010, p. 376) point out that there is little disagreement that IFRS are less precise and provide less guidance than U.S. GAAP and that, as a result, "a key difference between the two sets of standards is the amount of discretion that firms and managers have."

Despite concerns about increased opportunities for management's aggressive reporting under less precise accounting standards, we are unaware of any research on auditors' ability to curb aggressive reporting under IFRS. Somewhat surprisingly, there is limited evidence on auditors' response to aggressive reporting under U.S. GAAP's bright lines. The research that does exist involves pre Sarbanes-Oxley Act data and focuses on the effect of the existence of authoritative guidance (Trompeter 1994; Cuccia et al. 1995; Ng and Tan 2003) or the role of ambiguity in U.S. GAAP and auditors' incentives (Hackenbrack and Nelson 1996; Kadous et al. 2003; Blay 2005). This research generally finds that authoritative guidance helps auditors curb aggressive reporting, especially for unambiguous transactions. Nelson et al. (2002) specifically examine auditors' responses to attempted earning management in a field-based questionnaire. They find that the precision of the applicable U.S. GAAP standard and whether the transaction is structured to meet the standard interact to affect auditors' adjustment decisions. Consequently, we first establish conditions that help or hinder auditors' ability to curb aggressive financial reporting under less precise IFRS and more precise U.S. GAAP before examining the potential benefits of an auditor judgment framework.

One argument for the switch to IFRS is that auditors are free to focus on the economic substance of the transaction. Given the concern that auditors have become too rules-oriented (FASB 2004; Essaiades 2006), less precise standards force auditors to evaluate the transaction according to the relevant accounting principles rather than the prescribed rules. Additionally, these less precise standards provide auditors with more power to disallow aggressive reporting since clients cannot use transaction structuring to justify their reporting preferences. However, we expect that auditors' acceptance of the client-preferred aggressive reporting under these standards will depend on the clarity of the economic substance of the transaction. When auditors'

analysis of the transaction points to a clear accounting method, we expect IFRS to increase auditors' ability to restrain the client's aggressive reporting (our study's lease transaction). In contrast, when auditors' analysis does not point to a clear accounting method, we expect the ambiguity of the less precise IFRS to increase the likelihood auditors will accept the client's aggressive reporting (our study's revenue transaction). Stated formally, we hypothesize the following:

H1a: Without a judgment framework, auditors are less (more) likely to accept a client's aggressive reporting under less precise IFRS when the appropriate accounting method is clear (unclear).

Proponents in favor of the switch to IFRS also argue that rules-based standards, like U.S. GAAP, foster a "check the box" mentality that encourages transaction structuring around the rules and enable managers to account for the form rather than the economic substance of a transaction (Herz 2003; SEC 2003). Further, auditors are more likely to allow earnings management through transaction structuring when the governing rules are precise and transaction structuring is consistent with the rules (Nelson et al. 2002; Nelson 2003). For example, auditors are reluctant to make the "substance over form" argument against the client-preferred method when the transaction meets the bright lines, even though the bright lines do not apply in all circumstances (Nelson et al. 2002). Even after the Sarbanes Oxley-Act of 2002 introduced major regulatory reforms in an attempt to enhance audit quality, the PCAOB (2007, 2008) continues to express concern about auditors' ability to curb management's aggressive reporting. As such, we hypothesize that rules-based standards will increase the likelihood auditors will accept the client's aggressive reporting when the transaction is structured to meet the bright-line tests (our lease transaction), but such standards will decrease auditors' acceptance of the aggressive

reporting when the transaction fails to satisfy the specific criteria contained in the standards (our revenue transaction). Stated formally, we hypothesize the following:

H1b: Without a judgment framework, auditors are less (more) likely to accept a client's aggressive reporting under more precise U.S. GAAP when the transaction fails (meets) the standard's bright lines.

We hypothesize that both sets of accounting standards can help or hinder auditors' ability to curb aggressive reporting. As a result, there could be relatively more or less aggressive reporting under less precise IFRS than more precise U.S. GAAP. Accordingly, it is important to investigate the conditions under which auditors' judgments under IFRS differ from those under current U.S. GAAP. As noted above, more precise standards allow managers to structure transactions to account for the form rather than the economic substance of the transaction. Thus, auditors can more easily accept the client-preferred accounting method when the transaction is structured to meet the bright lines found in a more precise standard than when the standards lack any such bright-line tests. However, the lack of detailed guidance may make it difficult to apply a less precise standard to a complex transaction. The ambiguity regarding how to apply the accounting principles to a transaction that lacks a clear economic substance enables auditors to accept the client-preferred accounting method without having to consider whether the transaction meets the criteria of the more precise standard. In our study, we predict that the less precise IFRS revenue standard increases the likelihood auditors will accept the aggressive reporting relative to the U.S. GAAP revenue standard, while the less precise IFRS lease standard decreases the likelihood auditors will accept the aggressive reporting relative to the U.S. GAAP lease standard.

We formally hypothesize the following:

H1c: Without a judgment framework, the likelihood auditors accept a client's aggressive reporting is lower (higher) under less precise IFRS relative to more precise U.S. GAAP when the transaction's economic substance (fails to) contradicts the client-preferred accounting treatment.

Use of Counterfactual Reasoning

In response to the concerns about the quality of auditors' judgments, CIFIIR has proposed judgment guidance to encourage a disciplined decision making process. CIFIIR specifically states that one critical piece to making a reasonable judgment is the evaluation of the pros and cons of all reasonable alternatives (CIFIIR 2008). In other words, a key component of a reasonable accounting judgment is auditors' critical evaluation of the appropriateness of all alternative accounting methods given the transaction's underlying economics before deciding on the appropriate method.

Prior psychology research has investigated individuals' ability to generate arguments in favor of (pros) and against (cons) a particular position. Koriat et al. (1980) and Hoch (1985) found evidence that individuals tend to spontaneously generate supporting reasons for a given position, but must be explicitly instructed to consider counterfactual reasons for why that position may not be best. Most research on auditors' use of counterfactual reasoning focuses on the analytical review process. Evidence suggests that auditors do not spontaneously engage in counterexplanation, but that its use increases auditors' ability to identify unexpected fluctuations during analytical review (Koonce 1992; Kennedy 1995). Koonce (1992) finds that considering and documenting information not consistent with the target event leads to more reasoned judgments that incorporate information not otherwise considered. Similarly, Heiman (1990) reports that consideration of opposing scenarios increases auditors' perceptions of the plausibility and availability of alternative outcomes. These findings suggest that auditors using a judgment framework that encourages counterfactual reasoning by explicitly considering arguments against (cons) the client-preferred method of accounting will be less likely to accept the client's aggressive reporting preference.

Construal Level Theory

Although prior research suggests that counterfactual reasoning will reduce auditors' propensity to accept the client-preferred aggressive reporting method, Construal Level Theory (Liberman and Trope 1998; Trope and Liberman 2003; Trope et al. 2007) suggests that auditors may benefit more from a framework that psychologically distances auditors from their client's preferences. Construal Level Theory explains that individuals can use either concrete, low-level construals or abstract, high-level construals to represent events (Trope et al. 2007). Low-level construals focus on the specific details of the event, while high-level construals are schematic representations that extract the gist of the event from the available information (Trope and Liberman 2003). Given that managers often structure transactions to meet the criteria of their preferred accounting method, auditors need to distance themselves from the details of the transaction to objectively determine the accounting method that best reflects the economic substance of the transaction. Using Construal Level Theory, we posit that such psychological distancing will increase the quality of auditors' judgments by shifting their focus away from low-level construals of the transactional information and towards high-level construals that provide perspective on the economics of the transaction.

Our model illustrated in Figure 1 adapts Construal Level Theory to explain the relation between auditors' motivations and mindsets, their use of high-level and low-level construals, and their choice of accounting method. The first phase of the model involves a deliberative mindset characterized by objective analysis and effective processing of all relevant information regarding the feasibility and desirability of competing alternative outcomes (Gollwitzer et al. 1990; Taylor and Gollwitzer 1995). This deliberative mindset emerges *before* individuals decide on their preferred outcome (Gollwitzer 1990; Gollwitzer et al. 1990; Taylor and Gollwitzer 1995). Once

individuals choose their preferred outcome, individuals cross the Rubicon (or the point of no return to objective reasoning) and enter into an implemental mindset. This mindset is characterized by the overestimation of the desirability of the chosen alternative outcome and its feasibility (Taylor and Gollwitzer 1995), as well as closed-mindedness in the sense of concentrating on information that favors the chosen alternative (Gollwitzer et al. 1990).

[Insert Figure 1 here]

Although Construal Level Theory suggests that a deliberative mindset will enable auditors to choose the most appropriate accounting method, Gollwitzer (1990, p. 60) notes that not every “initiation of action is preceded by deliberation of the desirability of the underlying goal.” In other words, auditors may bypass the deliberative mindset that fosters unbiased processing if their motivation to please the client (by accepting the client-preferred accounting method) outweighs their motivation to be accurate. Such a result is consistent with prior research regarding auditors’ reduced objectivity and increased acceptance of the client-preferred accounting methods under ambiguous standards (e.g., Hackenbrack and Nelson 1996; Kadous et al. 2003; Blay 2005). In particular, Kadous et al. (2003) found that auditors’ tendency to support the client-preferred aggressive accounting method increased with auditors’ commitment to their directional goal to please the client. Moreover, auditors who were more committed to these directional goals identified the client-preferred method as the most appropriate method. Therefore, in an auditing context, Construal Level Theory suggests that the quality of auditors’ judgments will benefit from a shift back from an implemental mindset to a deliberative mindset that encourages unbiased processing of all alternative accounting methods.

In order to shift auditors’ mindset, Construal Level Theory suggests that auditors change from constructing low-level construals of the transactional information that focuses auditors on

the feasibility of accepting the client-preferred method to constructing high-level construals. These high-level construals provide auditors with psychological distance from the client's preferences so that they can gain perspective on the economics of the transaction. Prior psychology research finds that instructing individuals to consider the superordinate purpose ("why") of the outcome can achieve this psychological distance (Freitas et al. 2004). In other words, the act of considering "why" a transaction should be accounted for in a certain way may help auditors create high-level construals of the transaction that focus on the transaction's economic substance.

Auditor Judgment Frameworks

After identifying conditions under which auditors are more likely to accept the client's aggressive reporting absent the use of a judgment framework in our first set of hypotheses, we now examine how three different judgment frameworks affect auditors' judgments under U.S. GAAP and IFRS. Examples of each of these frameworks are included in the Appendix.⁸ The first framework, the *counterfactual framework*, is based on CIFIIR's recommendations and requires auditors to consider the pros and cons of the different accounting methods. This type of counterfactual reasoning has been examined in an analytical review context (e.g., Koonce 1992), but it has not been examined in an IFRS accounting method choice context. The second framework, the *why framework*, is the purest form of the framework suggested by Construal Level Theory. This framework explicitly requires auditors to consider only why the non-client-preferred accounting method should be accepted (rather than also considering why it should not). We designed the last framework, the *hybrid framework*, by combining features of both counterfactual reasoning and high-level construals suggested by Construal Level Theory. The

⁸ Each framework includes representative responses from actual participants. The boxes in each framework were initially empty for the participating auditors to complete.

framework encourages auditors to think broadly about why the transaction should and should not be accounted for in accordance with the client's preference. Our study contributes to theory and practice by examining three alternative judgment frameworks (one proposed to standard setters, one suggested by recent developments in psychology research, and one hybrid framework) in both a U.S. GAAP and IFRS context.

We first hypothesize that the effectiveness of a judgment framework is likely to differ under U.S. GAAP and IFRS. Nelson et al. (2002) found that auditors are less likely to require their clients to account for the substance of a transaction that has been structured to meet a more precise standard. Moreover, auditors have experience under U.S. GAAP and it will be difficult for them to unbiasedly consider the available alternative accounting methods. As a result, we expect that neither a judgment framework that employs counterfactual reasoning nor one that effectively induces a shift in mindset is likely to deter auditors from accepting the client-preferred aggressive accounting method when the transaction satisfies the bright lines. In contrast, by emphasizing the importance of the economics as opposed to the structure of the transaction, IFRS encourages auditors to examine the available transactional information at a higher level to determine how best to account for the economics of the transaction. We expect an effective judgment framework to enhance this big picture perspective. Although auditors may exploit the ambiguity in the less precise standards to justify their acceptance of the client-preferred method, this ambiguity also provides an opportunity for auditors to disallow the aggressive accounting method. Consequently, we expect that judgment frameworks that direct auditors to consider the arguments against the client-preferred method are likely to help auditors curb aggressive reporting. We hypothesize the following:

H2a: Employing a judgment framework under less precise IFRS reduces the likelihood that auditors accept a client's aggressive reporting.

H2b: Employing a judgment framework under more precise U.S. GAAP does not reduce the likelihood auditors accept a client's aggressive reporting.

If a judgment framework helps auditors curb aggressive financial reporting under less precise IFRS, it is important to understand each framework's relative effectiveness. Koonce (1992) explains that the requirement to think about and document counter arguments enhances the salience of these arguments, thereby reducing auditors' belief in the validity of the client-provided information. In directing auditors to consider arguments against the client-preferred accounting method, the *counterfactual*, *why*, and *hybrid frameworks* should all lead to more reasoned judgments. Construal Level Theory suggests that auditors' judgments will further benefit from the construction of high-level construals that provide perspective on the economics of the transaction. Accordingly, we predict that both our *why framework* and our *hybrid framework* will be more effective at helping auditors curb the client's aggressive reporting than the *counterfactual framework* when the economic substance of the transaction is clear and points to a specific accounting method (our lease classification transaction). In contrast, the construction of high-level construals that allow auditors to extract the economic gist of the transaction will not be as beneficial when the economic substance of the transaction and its accounting are unclear. Consequently, we predict that the frameworks will not differ in helping auditors curb aggressive reporting when the transaction's economic substance is unclear (our revenue recognition transaction). Therefore, we hypothesize the following:

H3a: Under less precise IFRS, auditors employing a *why* or *hybrid* framework are less likely to accept a client's aggressive reporting than auditors using a *counterfactual* framework when the appropriate accounting method is clear.

H3b: Under less precise IFRS, auditors employing a *counterfactual*, *why*, or *hybrid* framework are equally likely to accept a client's aggressive reporting when the appropriate accounting method is unclear.

II. RESEARCH METHOD

Participants

Two hundred practicing audit staff and senior associates participated in this experiment using a 2 x 2 x 4 mixed design. The auditors were from one of the Big 4 firms and participated while attending firm training. All experimental and case materials were randomly distributed among participants and had been pilot tested.⁹

Procedure

All participants first read a brief description of a company, BBC, that is a foreign private issuer allowed to file its financial statements in accordance with either U.S. GAAP or IFRS. Instructions asked participants to assume they were the auditors of the company. The participants were then told that the company has chosen to report its financial statements in accordance with IFRS (half of the participants) or U.S. GAAP (the other half of the participants). After reading the background material, participants completed two tasks, a revenue recognition task and a lease classification task, the order of which was varied across participants. The case booklets also contained the relevant accounting standards for each transaction under either U.S. GAAP or IFRS.

After reading the facts associated with one of the transactions described above and the applicable accounting standard, participants in the three framework conditions received an example of a completed judgment framework for a non-accounting task. Participants then completed a similar judgment framework for the company's accounting choice. Participants in the control group (i.e., *no framework*) had space to make any notes that they wished regarding

⁹ The case is based on materials provided by a Big 4 accounting firm that are intended to be used in intermediate accounting classes to illustrate the differences between U.S. GAAP and IFRS. We pilot-tested the case materials on seven accounting doctoral students.

the specific transaction. After this task, all participants indicated by binary choice the most appropriate accounting method. Participants followed the same process to reach a decision related to the second transaction. After the case materials were collected, participants answered demographic questions and manipulation checks.

Independent Variables

We manipulated three independent variables: *transaction*, *accounting standard precision*, and *judgment framework*. The first independent variable, *transaction*, was manipulated within participants. All participants analyzed the revenue recognition for a bundled (good and service) transaction and the classification of a lease. The revenue transaction was a bundled (good and service) sales arrangement. The company delivered a used packaging machine to the customer before year end, but was not able to install the equipment until after year end. Nevertheless, the company expressed a strong preference for recognizing the related revenue in the current period. The company sells similar new packaging equipment and installation contracts on a stand-alone basis. In order to determine whether or not to recognize any revenue, participants had to determine whether the transaction is one unit (i.e., the packaging machine and the installation services cannot be separated) or two separate units (i.e., the packaging machine and the installation services are separate units). For the lease classification, the company entered into a lease arrangement for a non-specialized piece of equipment at the beginning of the year. Case materials provided the lease term (67 percent of the remaining economic life of the equipment), the fair value of the equipment, the present value of the lease payments, the remaining economic life of the equipment (88 percent of the fair value of the equipment), and the unguaranteed residual value of the equipment. The case also noted that ownership does not transfer at the end of the lease term, but the company has the option to purchase the equipment at this time.

Although the client expressed a strong preference for classifying the lease as an operating lease, the participants had to review the facts of the lease to determine whether the lease should be classified as an operating or a capital lease.

The second independent variable, *accounting standard precision* was manipulated between participants. The more precise standards refer to the standards under current U.S. GAAP, while the less precise standards consist of the IFRS standards implemented internationally. We provided participants with the relevant section of the actual standards.¹⁰ Under current U.S. GAAP, FASB Accounting Standards Codification 605-25 provides specific criteria for determining the number of units of accounting in a multiple element sales arrangement, while International Accounting Standard 18 lacks any such criteria. Similarly, FASB Accounting Standards Codification 840-10-25-1 provides specific bright-line tests that dictate the classification of a lease. Conversely, International Accounting Standard 17's lease classification indicators do not provide any quantitative thresholds. We manipulated *accounting standard* between participants by varying whether the company chose to report its financials in accordance with U.S. GAAP or IFRS.

As depicted in Figure 2, we designed our experiment to provide unique contexts that allow us to test the joint effects of the transaction's economic substance and applicable accounting standards on auditors' judgments. For the revenue recognition transaction, the client's preference to accelerate revenue is discouraged by U.S. GAAP's bright lines, but not by less precise IFRS because of the relatively unclear economic substance. Conversely, the client's preference of accounting for the lease as an operating lease despite an economic substance

¹⁰ While the wording of U.S. GAAP and IFRS is not symmetric, auditors in practice would likely refer back to the actual standards.

suggesting the purchase of an asset is discouraged by IFRS, but not by U.S. GAAP's bright lines given the lease's structure.¹¹

[Insert Figure 2]

It is common for companies to sell a bundle of goods and/or services. However, auditing the revenue recognition for such transactions that have multiple elements is difficult because auditors must determine the number of distinct units within the bundle that have stand-alone value. This determination requires auditors to use their judgment when analyzing the terms of the transaction and other evidence supporting the valuation of the distinct units. Under IFRS, auditors are provided with little guidance for the determination of the number of distinct accounting units. Consequently, our revenue transaction allows us to explore whether the lack of precise guidance hinders auditors' ability to curb aggressive recognition of revenue. On the other hand, the bright-line tests included in U.S. GAAP provide an objective way to determine the number of accounting units. In our case, the transaction fails to meet the bright-line test for the client-preferred accounting method. Thus, our revenue transaction also allows us to examine a scenario where the bright-line tests found in rules-based standards help auditors curb managements' aggressive revenue recognition.

Unlike a bundled revenue transaction, the economic purpose of a leasing transaction is relatively clear upon review of the terms of the contractual lease agreement. Under IFRS the economic substance of the lease dictates its classification such that the lease is either capitalized if it essentially represents a sale of the asset or classified as an operating lease if the lessee only

¹¹ We rely on the solutions provided by the Big 4 accounting firm that developed the cases for the determination of likely solutions and the clarity of the economic substance of each transaction. We also discussed the firm's solutions with practitioners and colleagues. While all agreed with the likely solution in each condition, there is also some ambiguity in each condition. The original cases were intentionally designed with some ambiguity to encourage classroom discussion. It was important for us to maintain this ambiguity to provide a meaningful test of our judgment frameworks.

intends to use the asset for a finite period of time. In contrast, the specific lease terms (i.e., the structure of the contractual lease agreement) guide the classification of the lease under U.S. GAAP. In our experiment, management prefers to account for the lease as an operating lease in order to minimize the amount of debt on their balance sheet. Although our lease essentially represents the purchase of the asset, the terms of the lease have been structured to meet the bright-line tests included in U.S. GAAP for accounting for the transaction as an operating lease. Consequently, this setting allows us to examine a scenario where the bright-line tests included in U.S. GAAP hinders yet IFRS helps auditors curb managements' aggressive classification.

We also manipulated the third independent variable, *judgment framework* (no framework, counterfactual framework, why framework, hybrid framework), across participants. Participants in the *no framework* condition consider the applicable authoritative guidance under either U.S. GAAP or IFRS. This condition mirrors the current auditing environment where auditors are not currently using a formal judgment framework. The second condition, the *counterfactual framework*, reflects regulators' call for counterfactual reasoning. Specifically, CIFIr notes that a key component of a reasonable auditing judgment is consideration of the pros and cons of the different accounting method alternatives (CIFIr 2008). We required participants in the counterfactual framework condition to consider both the pros and cons of allowing the client-preferred method.

Our third condition (the *why framework*) based on Construal Level Theory requires auditors to consider why the non-client-preferred accounting method should be accepted. Because Construal Level Theory has not been tested in the auditing setting, it is not clear whether psychological distancing will be effective in combination with counterfactual reasoning. Thus, our final condition (the *hybrid framework*) asks auditors to use both counterfactual

reasoning and psychological distancing in thinking broadly about why the transaction should or should not be accounted for in accordance with the client's preference.

Dependent Variable

Our main dependent variable is auditors' binary choice of the most appropriate accounting method for each transaction. Participants either selected the client-preferred method (i.e., recognize revenue or classify lease as an operating lease) or the alternative (i.e., do not recognize revenue or classify lease as capital lease) for each transaction. Consistent with Kadous et al. (2003), we coded auditors' choice a 1 if they selected the client-preferred method, 0 otherwise. While the engagement partner ultimately decides on the appropriateness of the client-preferred method, audit staff and seniors will be actively involved as members of the audit team in researching the issue and, if necessary, building the argument to put before the client. Audit seniors are responsible for identifying and recommending any related audit adjustments. Thus, of interest is what these auditors believe is the appropriate accounting not, for example, the accounting actually agreed to after the partner's negotiation with the client.¹²

III. RESULTS

Descriptive Statistics

Two-hundred practicing auditors participated in our study. They have an average of 14 months of audit experience which does not differ between U.S. GAAP and IFRS conditions ($t_{194}=0.106$, $p = 0.915$). Their experience in auditing the transactions involved in the case materials also does not differ between these conditions: Only 14 out of 200 participants had

¹² We also recognize that very few auditors at any level have operated under IFRS in the U.S. However, because the audit cases incorporated into our experimental materials are intended for intermediate accounting classes, our participants possess the required audit and accounting knowledge to choose the most appropriate accounting method.

participated in an IFRS filing, with eight of these participants in the IFRS condition and six in the U.S. GAAP condition.

To verify that our participants attended to our manipulation of the applicable accounting standard, the post-experimental questionnaire asked each participant to indicate whether the company's financial statements were reported under U.S. GAAP or IFRS. Ninety five percent of the participants in the U.S. GAAP condition and 94 percent of participants in the IFRS condition correctly identified the applicable accounting standard.¹³ These analyses indicate a successful manipulation of accounting standard.

Tests of Hypotheses

Our main dependent variable is auditors' binary decision on whether to allow the client-preferred accounting for a revenue recognition decision and a lease classification decision. We use a repeated measures, binary logistic regression to test our hypotheses.¹⁴ Panel A of Table 1 contains the results of this regression.

[Insert Table 1 here]

Auditors' Reporting Decisions under IFRS and U.S. GAAP

Our first set of hypotheses (H1a-c) examines auditors' reporting decisions under IFRS and U.S. GAAP absent the use of a judgment framework. Cell means capturing the percentage of auditors accepting the client-preferred accounting method appear in Panel B of Table 1. In H1a we predict for less precise IFRS an effect for the clarity of the appropriate accounting method.

Specifically, we expect auditors to accept the client-preferred accounting method for the revenue

¹³ When we exclude the 11 participants who failed the accounting standard manipulation check, the results are entirely consistent with those reported in the paper using all participants.

¹⁴ Order does not significantly interact with any of the other variables, but does have a significant main effect. Therefore, our analyses control for order. Auditors who complete the revenue task first accept the client-preferred method significantly more frequently (133/202 = 66%) than auditors who complete the lease task prior to the revenue task (105/198 = 53%) using Fisher's Exact Test ($p=0.006$). The client's structuring of the lease transaction appears to increase auditors' professional skepticism when they next analyze the revenue transaction.

transaction more frequently than for the lease classification under IFRS. As indicated in Panel B of Table 1, the hypothesized contrast is statistically significant ($\chi^2 = 6.23$, one-sided $p = 0.006$), supporting H1a. This means that less precise IFRS can help or hinder auditors' ability to curb aggressive reporting, depending on whether the auditor's transaction analysis points to a clear accounting method.

Opponents of IFRS argue that the bright lines present in U.S. GAAP help auditors curb management's aggressive reporting. H1b predicts that a more precise standard will decrease auditors' acceptance of the client-preferred method only when the client-preferred method fails the standard's bright-line test. In the context of our experiment, we expect that auditors will accept the client-preferred accounting method for the lease classification more frequently than for the revenue transaction under U.S. GAAP. The results in Panel B of Table 1 show that the difference, while in the hypothesized direction, is not statistically significant ($\chi^2 = 0.53$, one-sided $p = 0.233$).¹⁵

Next we compare auditors' decisions under IFRS and U.S. GAAP. H1c predicts that the less precise IFRS lease standard helps auditors curb the client-preferred aggressive reporting relative to the more precise U.S. GAAP standard by providing a clearer principles-based alternative; while the IFRS revenue standard's lack of guidance for addressing a transaction's ambiguous economic substance hinders auditors in curbing the client-preferred aggressive reporting relative to more precise U.S. GAAP. The statistically significant results of this

¹⁵ This result likely reflects participants' appreciation of the tension in U.S. GAAP between substance and form. Overall, 62 percent of the time participants accepted the client-preferred method and believed this method inappropriate 38 percent of the time. Nelson et al. (2002) find in their field-based survey that auditors report adjusting 44 percent of managers' attempted earnings management. The structuring of the lease to meet U.S. GAAP's bright lines likely influenced the 33 percent of participants who judged it inappropriate to classify the lease as operating despite the lease meeting U.S. GAAP's bright lines. In the ambiguous revenue recognition transaction, 46 percent of participants judged it inappropriate to recognize the revenue where all U.S. GAAP's bright lines were not met. As a point of comparison, Nelson et al. (2002) report auditors adjusted 21 percent of structured transactions and 47 percent of transactions not structured.

hypothesized contrast detailed in Panel B of Table 1 supports H1c ($\chi^2 = 4.76$, one-sided $p = 0.015$). These results show that IFRS with its less detailed guidance and focus on principles compares favorably to U.S. GAAP in helping auditors curb a client's aggressive reporting when the economic substance of the transaction is relatively clear, but it compares unfavorably when the auditor's transaction analysis does not clearly point to an accounting method.

Use of a Judgment Framework to Curb Aggressive Reporting

Our second and third sets of hypotheses explore the ability of a judgment framework to help auditors curb managements' aggressive reporting. Cell means capturing the percentage of auditors accepting the client-preferred accounting treatment (presented both aggregated across frameworks and separately by specific framework) under U.S. GAAP and IFRS appear in Panel C of Table 1.

We first examine the general usefulness of a judgment framework as auditors in practice are currently not required to use a judgment framework in this context. H2a predicts that employing a judgment framework under less precise IFRS reduces the likelihood that auditors will accept the client-preferred aggressive accounting method. The results of the hypothesized contrasts in Panel D of Table 1 support H2a ($\chi^2 = 1.90$, one-sided $p = 0.084$). H2b predicts that a judgment framework does not influence auditors' propensity to side with the client under more precise U.S. GAAP, and we find this to be the case ($\chi^2 = 0.27$, $p = 0.603$). These results support the call for an auditing judgment framework as the U.S. moves to less precise accounting standards.

To determine which judgment framework is most beneficial to auditors operating under less precise IFRS, we compare auditors' propensity to side with the client under each of the three frameworks in Panel E of Table 1. Our third set of hypotheses predicts that the effectiveness of

the judgment framework depends on the clarity of the underlying economic substance of the transactions. Specifically, H3a predicts that auditors' judgments will benefit from a framework that facilitates the construction of high-level construals when the economic substance of the transaction is clear and indicative of the most appropriate accounting method. The results detailed in Panel E of Table 1 provide support that auditors employing both the *why framework* ($\chi^2 = 1.72$, one-sided $p = 0.095$) and the *hybrid framework* ($\chi^2 = 2.03$, one-sided $p = 0.077$) are less likely to accept the client's preferences regarding the lease classification compared to the *counterfactual framework*. H3b predicts that auditors will not incrementally benefit from a framework that enables them to extract the economic gist of the transaction when the transaction's economic substance is unclear. Consistent with this hypothesis, we find no significant differences between the frameworks in curbing auditors' acceptance of the client's aggressive reporting in the more ambiguous revenue recognition task (*why*: $\chi^2 = 0.01$, $p = 0.942$; *hybrid*: $\chi^2 = 0.12$, $p = 0.726$).

Additional Analysis

Given that prior research suggests that auditors' dominant goal influences their preferred accounting method (Nelson 2006), we also collected goal commitment ratings on auditors' accuracy goal and their goal of pleasing the client.¹⁶ Of interest is what goal, if any, dominates auditors' judgments and whether the dominant goal is affected by IFRS versus U.S. GAAP.

To determine participants' dominant goal commitment, we used a scale refined and validated by Klein et al. (2001). The Klein et al. scale requires participants to indicate their level

¹⁶ Prior accounting research has found that auditors' economic goals to please their clients can impair their judgments (e.g., Hackenbrack and Nelson 1996; Kadous et al. 2003; Blay 2005). On the other hand, prior research has identified many benefits associated with auditors' accuracy goal dominating their goal to please the client. For example, auditors document more relevant information (Koonce et al. 1995), avoid over-weighting recent information (Kennedy 1993), identify more important information (Tan 1995), and perform higher-quality ratio analysis (Ashton 1990; Tan and Kao 1999) when their incentives encourage accurate judgment.

of agreement with five items for each goal on five-point Likert scales. Participants provided agreement ratings for two goals: the accuracy goal achieved by carefully analyzing all of the BBC's case information and the goal of pleasing the client reached by building a justifiable case for the accounting methods preferred by the client. To measure the dominant goal, we first performed a factor analysis on the responses to the ten items related to the two goals. The eigenvalue for the first 2 factors are 3.869 and 2.741 and all other eigenvalues are less than 1. In addition, the first 2 factors explain 66 percent of the variance in the measures. The Cronbach's alpha for the five questions related to the accuracy goal is 0.84, while the Cronbach's alpha for questions capturing the goal of pleasing the client is 0.86. We then subtracted each participant's commitment to pleasing the client factor score from their commitment to accuracy factor score to determine the dominant goal. A positive difference indicates that auditors' accuracy goal dominates their goal of pleasing the client.

Panel A of Table 2 presents a two-way ANOVA to test whether auditors' dominant goal differs under the two sets of accounting standards. The cell means provided in Panel B of Table 2 suggest that auditors exhibit a stronger commitment to accuracy than pleasing the client. We find that auditors' commitment to accuracy is greater under less precise IFRS than more precise U.S. GAAP ($F = 8.073, p = 0.005$). This result suggests that the accounting standards themselves can affect auditors' commitment to their competing goals of pleasing the client and ensuring the accuracy of the financial statements.

[Insert Table 2 here]

IV. CONCLUSION

In this paper, we investigate the effect of judgment guidance on auditors' choice of the most appropriate accounting method under less precise IFRS and more precise U.S. GAAP. Our

study is motivated by concerns regarding the quality of auditors' judgments in light of the U.S.'s anticipated adoption of IFRS and, more generally, accounting standards that are more general and provide less guidance. These concerns have prompted a call for judgment guidance for the application and evaluations of auditors' judgments. However, regulators, standard setters, and auditors do not know how such guidance will affect the overall quality of auditors' judgments. Further, little is known about how auditors judge and decide on the most appropriate accounting method under less precise standards (i.e., IFRS) compared to more precise standards (i.e., U.S. GAAP).

Consistent with our expectations, our results indicate that less precise IFRS can help auditors curb the client's aggressive reporting preference relative to more precise U.S. GAAP. However, ambiguity regarding how to apply the accounting principles to a transaction that lacks clear economic substance results in less precise IFRS hindering auditors' ability to curb the client's aggressive reporting relative to more precise U.S. GAAP. These results corroborate standard setters concerns about auditors' ability to restrain aggressive reporting in an IFRS setting. We also find that a judgment framework decreases auditors' acceptance of the client-preferred aggressive accounting method under less precise IFRS, but not under more precise U.S. GAAP. However, the effectiveness of the different judgment frameworks depends on the clarity of the economic substance of the transaction. When the transaction's economic substance is clear, the judgment frameworks based on Construal Level Theory are more effective at helping auditors to curb aggressive reporting than the counterfactual framework based on the proposal of CIFI_R. However, the framework based on CIFI_R's suggested use of counterfactual reasoning is just as effective when the transaction's economic substance is unclear. These results support

regulators' efforts to develop judgment guidance for auditors but suggest going beyond guidance based solely on counterfactual reasoning.

Our study makes several contributions to research and practice. We contribute to the auditor judgment literature by being the first to experimentally examine auditors' determination of the correct accounting treatment under IFRS as compared to U.S. GAAP. In particular, we find that auditors' ability to restrain managers' opportunistic judgments under IFRS depends on the clarity of the economic substance of the transaction. Further, we find that while standards that provide greater guidance enable auditors to more effectively curb managers' aggressive reporting in certain situations, the bright lines in these standards also facilitate auditors' acceptance of managements' preferences under different circumstances. Second, our findings provide experimental evidence on the ability of a judgment framework to improve audit quality. Our results also suggest the use of a judgment framework under IFRS, but not U.S. GAAP, bolsters auditors' ability to restrain managers' aggressive reporting. However, our reliance on Construal Level Theory suggests a modification to the approach proposed by CIFiR. Our study is therefore helpful to standard setters as they consider the costs and benefits of proposed auditor judgment guidance. The recent convergence project exposure drafts on revenue recognition and leases suggest that the benefits are likely to be standard specific. The very limited guidance provided in the revenue recognition exposure draft argues for a judgment framework, while the mandate included in the lease exposure draft that all leases be recorded as capital leases reduces the role of judgment and the need for a judgment framework. Finally, our study provides insight regarding auditors' dominant goal commitment under the two accounting standards. In particular, evidence of auditors' heightened commitment to accuracy under IFRS compared to U.S. GAAP is encouraging.

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FIGURE 1

Construal Level Theory Applied to an Accounting Method Decision
(Adapted from Gollwitzer 1990; Trope and Liberman 2003; Trope et al. 2007)

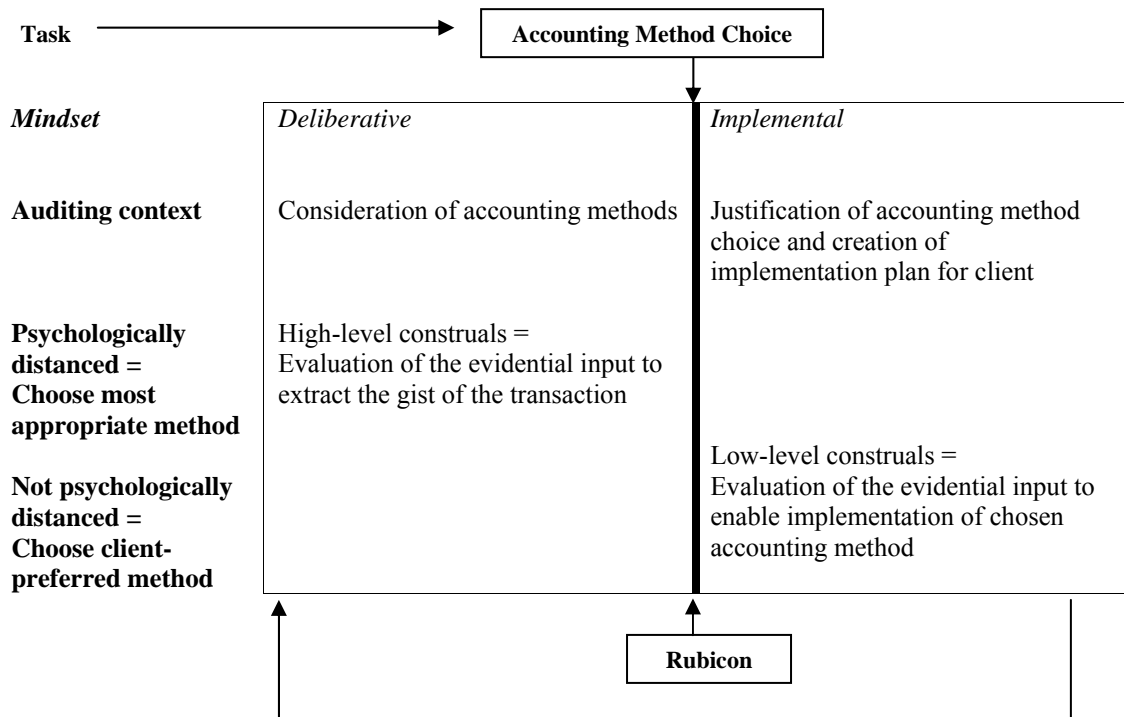


FIGURE 2

Experimental Design

	U.S. GAAP	IFRS
Transaction 1: Revenue Recognition <ul style="list-style-type: none">• Client preference: Accelerate revenue• Economic substance: Unclear	Bright lines discourage client-preferred aggressive reporting Predict relatively conservative accounting → Defer recognition of revenue (against client preference) Cell A	Principle does not discourage aggressive reporting Predict relatively aggressive accounting → Recognize revenue (consistent with client preference) Cell B
Transaction 2: Lease Accounting <ul style="list-style-type: none">• Client preference: Operating lease• Economic substance: Clear (capital lease)	Bright lines do not discourage aggressive reporting Predict relatively aggressive accounting → Operating lease (consistent with client preference) Cell C	Principle discourages aggressive reporting Predict relatively conservative accounting → Capital lease (against client preference) Cell D

TABLE 1

Auditors' Acceptance of Client-Preferred Method

Panel A: Repeated Measures Binary Logistic Regression

Source of Variation	df	X2	p-value
Standard	1	1.63	0.201
Framework	3	1.41	0.704
Task	1	8.04	0.005
Order	1	8.05	0.005
Standard*Framework	3	3.28	0.351
Standard*Task	1	15.91	<0.001
Framework*Task	3	1.28	0.734
Standard*Framework*Task	3	0.43	0.934

Panel B: Test of H1

% of Auditors Accepting Client-Preferred Accounting: Mean (SE) [N] Cell

	No Framework	
	U.S. GAAP	IFRS
Revenue Recognition	0.54 (0.509) [24] A	0.81 (0.402) [26] B
Lease Classification	0.67 (0.482) [24] C	0.46 (0.508) [26] D

Planned Contrasts	df	X2	p-value
H1a: Without a judgment framework, auditors are less (more) likely to accept a client's aggressive reporting under less precise IFRS when the appropriate accounting method is clear (unclear). Test: B>D	1	6.23	0.006
H1b: Without a judgment framework, auditors are less (more) likely to accept a client's aggressive reporting under more precise U.S. GAAP when the transaction fails (meets) the standard's bright lines. Test: C>A	1	0.53	0.233

H1c: Without a judgment framework, the likelihood auditors accept a client's aggressive reporting is lower (higher) under less precise IFRS relative to more precise U.S. GAAP when the transaction's economic substance (fails to) contradicts the client-preferred accounting treatment.

1 4.76 0.015

Test: (B+C) > (A+D)

Panel C: % of Auditors Accepting Client-Preferred Accounting: Mean (SE) [N] Cell

	U.S. GAAP				
	Frameworks				Collapsed Across Frameworks
	No Framework	Counterfactual Framework	Why Framework	Hybrid Framework	
Revenue Recognition	0.54 (0.509) [24] A1	0.57 (0.507) [23] A2	0.58 (0.504) [26] A3	0.71 (0.464) [24] A4	0.62 (0.490) [73]
Lease Classification	0.67 (0.482) [24] B1	0.65 (0.487) [23] B2	0.62 (0.496) [26] B3	0.71 (0.464) [24] B4	0.66 (0.478) [73]
	IFRS				
	Frameworks				Collapsed Across Frameworks
	No Framework	Counterfactual Framework	Why Framework	Hybrid Framework	
Revenue Recognition	0.81 (0.402) [26] C1	0.70 (0.465) [27] C2	0.69 (0.471) [26] C3	0.75 (0.442) [24] C4	0.71 (0.455) [77]
Lease Classification	0.46 (0.508) [26] D1	0.48 (0.509) [27] D2	0.31 (0.471) [26] D3	0.29 (0.464) [24] D4	0.36 (0.484) [77]

Panel D: Test of H2

Planned Contrasts	df	X2	p-value
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H2a: Employing a judgment framework under less precise IFRS reduces the likelihood that auditors accept a client's aggressive reporting.

1 1.90 0.084

Test: (C1+D1) > (C2+C3+C4+D2+D3+D4)/3

H2b: Employing a judgment framework under more precise U.S. GAAP does not reduce the likelihood auditors accept a client's aggressive reporting.
 Test: $(A1+B1) = (A2+A3+A4+B2+B3+B4)/3$

1

0.27

0.603

Panel E: Test of H3

Planned Contrasts

		df	X2	p-value
H3a: Under less precise IFRS, auditors employing a <i>why</i> or <i>hybrid</i> framework are less likely to accept a client's aggressive reporting than auditors using a <i>counterfactual</i> framework when the appropriate accounting method is clear. Test: $D2 > D3$ and $D2 > D4$	Why	1	1.72	0.095
	Hybrid	1	2.03	0.077
H3b: Under less precise IFRS, auditors employing a <i>counterfactual</i> , <i>why</i> , or <i>hybrid</i> framework are equally likely to accept a client's aggressive reporting when the appropriate accounting method is unclear. Test: $C2 = C3$ and $C2 = C4$	Why	1	0.01	0.942
	Hybrid	1	0.12	0.725

The *dependent variable* is coded 1 if the auditor chooses the client-preferred accounting treatment, 0 otherwise. All directional planned contrasts have one-tailed p-values.

TABLE 2**Impact of Accounting Standards on Auditors' Dominant Goal Commitment****Panel A: Two-way ANOVA (includes all observations)**

Source of Variation	df	MS	F	p-value
Standard	1	39.004	8.073	0.005
Framework	1	1.694	0.351	0.554
Standard * Framework	1	6.765	1.400	0.238
Error	189	4.832		

Panel B: Dominance of Auditors' Accuracy Goal Over Please Client Goal: Mean (SE) [N] Cell

	U.S. GAAP	IFRS
No Framework	0.07 (2.240) [23] A	1.55 (2.057) [25] B
Framework	0.72 (2.113) [71] C	1.33 (2.308) [74] D

The dependent variable is calculated as auditors' Commitment to Accuracy factor score less their Commitment to Pleasing the Client factor score.

APPENDIX

BBC Judgment Framework

Please complete the framework for BBC's revenue recognition decision.

Issue: Recognize revenue for BBC's transaction in 2008

Pros:

- BBC prefers to recognize revenue in 2008 rather than in 2009.
- The value of the installation services can be identified since BBC usually sells installation contracts separately for \$50K.

Cons:

- The used packaging machine cannot package any apparel until 2009.
- Economic benefits associated with the transaction will not flow to College Gear, Inc. until the unit is installed.

BBC Judgment Framework

Please complete the framework for BBC's lease classification decision.

It is improper to allow the client to engage in off-balance sheet financing for what is essentially the purchase of the equipment.

Even more broadly, why?



The substance of the lease arrangement looks like a capital transaction.

Thinking more broadly, why?



The present value of the lease payments is 88% which I consider to be substantially all of the fair value of the equipment.

Why would you do this?



Classify BBC's equipment lease as a *capital* lease rather than an operating lease



<START HERE>

BBC Judgment Framework

Please complete the framework for BBC's lease classification decision.

